FARM LOSSES UNDER THE TAX REFORM ACT OF 1969: KEEPIN' 'EM HAPPY DOWN ON THE FARM

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When neither the Treasury Department nor the American farming industry was highly sophisticated, the Treasury Department made a number of decisions which continue to plague us today, and which have led to certain well-publicized abuses in the farm tax area. During the last session of Congress, there appeared, for the first time, some hope that Congress would take positive action to correct these abuses. In view of the 1969 legislation, however, one has the feeling that the farm tax loss problem is somewhat like the problem of the poor: it may be with us always. The purpose of this article is to analyze the Tax Reform Act of 1969[1] as it affects farm losses, and to demonstrate that it provides little overall reform in the farm tax loss area.

I. THE PROBLEM

The tax problem in the farm industry is the result of early administrative decisions which prescribed different accounting principles for farming and nonfarming operations. Farmers are permitted to expense items which are capital items under commercial accounting principles, most notably, items such as the cost of raising livestock[2] and costs involved in the pre-operation stage of orchards and ranches.[3] In addition, farmers may use the cash method of accounting and ignore year-end inventories as well as payables and receivables,[4] although one could hardly convince an accountant that these techniques lead to a clear reflection of income. In either case there is a deduction of costs before the income produced by them is realized. If there is other income to absorb these premature deductions, the resulting tax savings return a large part of the taxpayer's cost to him before he makes a sale of the goods produced. He is thus treated more favorably than other taxpayers who must await a disposition of property before deducting costs. This favorable treatment is aggravated by

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1 P.L. 91-172, 91st Cong., 1st Sess. (1969) [hereinafter cited as the Act or, the 1969 Act].

2 T.D. 2153, 17 Treas. Dec. Int. Rev. 101 (1915), as amended by T.D. 2665, 20 Treas. Dec. Int. Rev. 45 (1918).

3 Treas. Regs. 45, art. 110 (1917). Treas. Regs. 33, art. 4 (1917), required these costs to be capitalized.

4 Treas. Reg. § 1.61-4 (1957); § 1.471-6 (1958).

permitting the proceeds from the sale of many farm assets to be reported as capital gain, most notably proceeds from sales of livestock culled from breeding herds, and orchards.[5] These problems have been extensively discussed elsewhere,[6] and it seems unnecessary at this juncture to do more than note their operations under pre-1969 rules. The effect of the 1969 Act is considered later.

The pre-1969 rules conferred substantial tax benefits upon certain farm investments. In some cases, the tax benefits exceeded economic losses and, thus, made profitable those operations which, absent the tax savings, were economically unsound.[7] In other cases, depending in large measure upon the amount of income earned in other endeavors, the rules conferred a substantial subsidy upon economically profitable operations. For example, a taxpayer using the cash method of accounting might have incurred expenses of $200,000 in raising a breeding herd. If he were in the 70 percent tax bracket, the current deduction of these expenses would have produced a tax savings of $140,000. The herd, of course, would have a zero basis because the cost of raising had been entirely deducted, and upon its sale, the entire sale price, including the recovery of the expenses of raising the herd, would be taxed only at capital gains rates. If the taxpayer had sufficient income to qualify for the alternative tax under Section 1201 of the Code, prior to amendment by the 1969 Act, the resulting tax rate would have been 25 percent, giving a tax of $55,000, or less than one-half of the $140,000 tax savings realized from the deduction of the raising costs. Thus, the taxpayer who realized an economic profit of $20,000 would also have a net benefit from the government in the form of a reduction on taxes on other income in the net amount of $85,000. Obviously, a taxpayer who enjoyed this kind of largess would be likely to begin the cycle anew by starting a new breeding herd which would later be sold at capital gains rates.

Similar advantages were available to developers of citrus groves, and are still available to those who develop fruit orchards and vine-

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[5] Int. Rev. Code of 1954, § 1231, and Albright v. United States, 173 F.2d 339 (8th Cir. 1949). References to section numbers are to the Internal Revenue Code of 1954 unless otherwise noted.

[6] Hawkinson, Farm Expenses and General Accounting Principles, 22 Tax L. Rev. 237 (1967); Hjorth, Cattle, Congress, and the Code: The Dangers of Tax Incentives, 1968 Wis. L. Rev. 641 (1968); Allington, Farming as a Tax Shelter, 14 So. D. L. Rev. 181 (1969); Davenport, A Bountiful Tax Harvest, 48 Texas L. Rev. 1 (1969); House Comm. on Ways and Means and Senate Comm. on Finance, Tax Reform Studies and Proposals of the U.S. Treasury Dep't, 91st Cong., 1st Sess. 151 (1969) [hereinafter cited as Treasury Studies]; Hearings on Tax Reform Before the House Comm. on Ways and Means, 91st Cong., 1st Sess. 5047 (1969) [hereinafter cited as Tax Reform 1969]; and Pitcarin and Chandler, Tax Advantages of Cattle Operations, 1 P.H. Tax Ideas ¶ 17,013 (1968).

[7] See Treasury Studies, supra note 6, at 154.

yards.[8] The assets involved require several years to mature and, during the pre-operation period, the development costs such as water, fertilizer, cultivation, pruning and spraying may be deducted as ordinary expenses of the business.[9] When the operation reaches the stage where it is ready to begin producing a profitable crop, the asset may be sold in a transaction which qualifies for the lower capital gains tax rates.

In recent years, these attractive tax features have been literally packaged and sold.[10] Whatever may have been the purpose of these rules in the beginning, it would seem obvious that they were not intended to permit the widespread sale and syndication of tax benefits arising from farm tax accounting rules. This belief apparently was shared by both the House Ways and Means Committee and the Senate Committee on Finance when the 1969 Tax Reform Act was under consideration. Yet, it is doubtful that the provisions of the Act which deal with the farm loss problem will constitute more than a half-step in the direction of correcting abuses in some few instances.

II. Possible Solutions[11]

A. *A Change in Accounting Rules*

The solution which would have been most effective but which had no active sponsor, other than in academic circles,[12] was the revocation

[8] The Act added § 278 to the Code providing that certain development costs with relation to citrus groves must be capitalized. The section does not extend to non-citrus orchards or vineyards.

[9] In An Analysis of Orchard Development Costs, (University of California Agricultural Extension Mimeo, 1968), Mr. A. Doyle Reed estimates the development cost (exclusive of land, tree, and planting costs) at $1,255 per acre for almonds; $1,745 for apples; $1,233 for apricots; $2,401 for pears; $4,395 for avocados; and various other prices for other plants. These amounts apparently would have been deductible before the Tax Reform Act of 1969.

[10] See, e.g., an advertisement by Citrus Investments, Inc. in the February, 1968 issue of Air Line Pilot reprinted at 114 Cong. Rec. 29594 (1968) at the request of Senator Metcalf. See also the offering brochures of Ceres Land Co., Black Watch Farms, Inc., Eight Bells Angus, Inc., Chateaubriand, Inc., Oppenheimer Indus., Inc., and others.

[11] From time to time a number of solutions to the farm loss problem have been suggested, but at this point only three of them merit discussion. Without attempting to be exhaustive, some of the other proposals might be noted. There was a bill introduced by Senator Miller of Iowa, S. 1560, 91st Cong., 1st Sess. (1969), reprinted at 115 Cong. Rec. 6395 (1969). This bill would have limited the farm deductions of nonfarmers to farm income except in the case of an individual whose principal residence is on a farm. In such case, the limit on farm deductions would have been the total of (a) farm income, (b) wages and salaries, (c) timber income, and (d) royalties derived from farm property. A farmer would have been entitled to claim all of his farm deductions. A farmer was defined as a taxpayer whose net income from farming for the three preceding years equalled two-thirds of his total net income for such years. For this purpose, net farm income included the full amount of gain on the sale or exchange of assets. Total income, however, excluded all such gains except those incurred on farm assets. Certain deductions were not disallowed even though attributable to the farm. These included deductions

of the right of farmers to use the cash accounting method and to deduct capital expenditures. This course might also have included the denial of capital gain on the sale of certain farm assets. This solution was never proposed as a bill. With the exception of the capital gain

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arising from (a) casualty and weather conditions, (b) experimental farming, and (c) egg or broiler operation. Also, farms acquired from decedents, or by foreclosure, or operated by an estate would have been excepted for limited periods. Provisions were made to consolidate sole proprietorships with partnerships and subchapter S farm income and losses.

The bill had many weaknesses. First, it raised difficult definitional problems. What is a principal residence? What is a farm on which the principal residence must be located? This differs radically from the problem of defining farm income and expense—a feature common to many proposals. Second, a farmer could continue to offset nonfarm income, e.g., wages, by farm losses. A nonfarmer could also do so if he lived on a farm. There would appear to be no policy supporting this exception. Third, the sponsor conceded that the definition of "net farm income" and "total income" are designed to prevent, at least to some extent, application of the bill to livestock—probably the worst abuse. See Tax Reform 1969 at 2003-004, (remarks of Senator Miller). Fourth, the definition of a farmer depended on a new concept of farm income which is not the same as that set out for the filing of a declaration of estimated tax. Thus, a new category of farmers would have been created. Fifth, this approach was not directed toward either one of the causes of the farm loss problem, i.e., capital gain and simplified accounting rules. Its effect thus would be difficult to predict.

For another approach to the problem, see Sweeney, The Farm Loss Deduction, 53 A.B.A.J. 447 (1967). Sweeney advocated amending § 165 to disallow farm losses unless there was a reasonable expectation of profit. Five consecutive loss years would be considered proof that the expectation was not reasonable, in absence of clear and convincing evidence to the contrary.

This solution is technically deficient since there is no statutory definition of a farm "loss," and the "loss" arises usually because § 162 deductions (not § 165) exceed ordinary income. It is also premised on the belief that the farm loss problem may be one of "hobby losses." The suggestion is rejected in a reply article: Dickinson, The Farm Loss Deduction: A Reply, 53 A.B.A.J. 1111 (1967). See also Hjorth, supra note 6, at 644, 670, where the author proposed a § 1245 recapture and denial of § 1231 treatment in the absence of a failure to capitalize growing costs. This proposal does not reach citrus groves, although it could be so broadened. It also raises accounting problems and presents problems similar to those which are presented by the excess deduction account, the approach taken in the 1969 Act.

See also the letter from the National Livestock Committee, Tax Reform 1969, Hearings Before the House Comm. on Ways and Means, 91st Cong., 1st Sess. at 2056, 2059-060 which suggests a § 1245 recapture and lengthening of lives for an asset to qualify under § 1231. As is demonstrated in attachments to the letter suggesting this approach, considerable tax subsidy remains. This proposal must, therefore, be adjudged largely ineffective.

It has been suggested that all livestock sales be reported as ordinary income. While that approach would be helpful, it would not handle the overall farm loss problem. First, such treatment would not reach citrus groves, the do-it-yourself averager, the special deductions under §§ 175, 180, and 182, nor the "hobby" farmer in many cases. Second, from a conceptual viewpoint, without considering the deferral benefit, EDA is the equivalent of a forced capitalization of costs which permits only the actual economic profits to be reported as capital gain. Thus, treating all livestock sales proceeds as ordinary income would be going just one step further and requiring the economic profit to be taxed as ordinary income. This approach might be a step in the right direction, but it does nothing to reduce the benefit of the deferral although it would obviously reduce the net difference between the benefit of deferral and the detriment of the tax.

[12] See Hawkinson, Hjorth, Allington, and Davenport, supra note 6.

aspect, it apparently could have been promulgated by the Treasury Department in response to a suggestion by the Supreme Court.[13] The Treasury Department, however, had apparently rejected this answer in 1969, and had begun a search for other solutions.

Failure to take this step appears to be based upon both political reasons and alleged practical problems.[14] Since the practical problems are not insuperable,[15] the justifications offered for not proposing revised accounting rules appear to be mere rationalizations rather than valid reasons supporting inaction. Although this solution to the farm loss problem was not chosen, it remains available as the preferable alternative to other possible methods, including, in particular, the method actually chosen in the 1969 Act.

B. *The Denial of the Right to Deduct Farm Losses*

The first indication that the Treasury Department had seriously considered legislative solutions to the farm tax loss problem appeared in a letter to the Chairman of the Senate Finance Committee on July 11, 1968.[16] Senator Metcalf of Montana had introduced a bill in the 90th Congress which would have denied some taxpayers the right to deduct farm losses.[17] In commenting upon the bill, the Treasury Department suggested that it be modified so as to place a limitation upon the amount of farm loss that any nonfarmer could claim, so long as he did not affirmatively elect specified accounting procedures which would have eliminated most farm loss problems. This suggestion was reflected in another bill[18] introduced by the Senator in late 1968 which was carried over to the 91st Congress as S. 500.[19] Essentially, the bill provided that a taxpayer having more than $15,000 of nonfarm income would be denied the benefit of deducting his farm loss from other income unless he chose to compute the farm loss under accounting methods which require capitalization of costs.

The theory of the Senator's bill seems to have been that the simplified accounting rules should be preserved for the "real" farmers, and that such a farmer could be defined by his lack of income from nonfarm sources. If nonfarm income was above a substantial level,[20] there was reason to believe that the particular farming operation was engaged in for the purpose of offsetting nonfarm income with the farm

13 United States v. Catto, 384 U.S. 102 (1966).

14 Id. at 110-11 and n.15; see also Allington, supra note 6, at 203-04.

15 See Davenport, supra note 6, at 14-19.

16 Reprinted at 114 Cong. Rec. 21705 (1968).

17 S. 2613, 90th Cong., 1st Sess. (1967).

18 S. 4059, 90th Cong., 2nd Sess. (1968), reprinted at 114 Cong. Rec. 27562 (1968).

19 S. 500, 91st Cong., 1st Sess. (1969).

20 The bill chose $15,000 as the level at which to commence the disallowance of farm losses. 114 Cong. Rec. 27562 (1968).

loss. Or. even if the farm operation were not engaged in merely for balancing purposes, the tax benefits of farm losses created by the farm tax accounting rules were so great at high income levels that these benefits should be denied. The first conclusion was amply supported by data which demonstrated that as income from nonfarm sources grew, taxpayers had a remarkable propensity to run farm operations at a loss despite the fact that they ran their other businesses at a profit. It seemed unlikely that such individuals engaged in farming and actually lost money through mismanagement or bad investment decisions. Rather, in view of the extensive literature explaining the tax benefits to be reaped from the farm accounting rules, it seemed more likely that wealthy taxpayers were investing in farm assets because of the tax savings available. It thus seemed correct to limit the loss such taxpayers could claim.[21]

A similar approach was suggested by the Treasury Department itself in *Treasury Studies*, published shortly after the Johnson Administration departed Washington.[22] By that time, Senator Metcalf had obtained the support of numerous Senators and Congressmen,[23] in addition to that of the National Farmers Union, the National Grange, and the American Farm Bureau Federation.[24] The opponents of Senator Metcalf appeared mainly to be those having a vested interest in the payment and receipt of the federal subsidy provided by the farm tax accounting rules.

C. *The Excess Deductions Account*

For reasons which have never been completely articulated, the newly-arrived Nixon Administration endorsed neither the approach of the *Treasury Studies* nor that put forth by Senator Metcalf. Instead, it offered the excess deductions account (EDA), a new version of the 1963 proposal of the Kennedy Administration.[25] In general, the proposal might be called a recapture proposal. Recapture proposals do not disallow deductions; rather excessive deductions are allowed, and sales proceeds are then treated as ordinary income to the extent of the "recapture." The Administration proposal thus made no suggestion that deductions be curbed. Instead, it would have required some proceeds realized on the sale of some farm assets to be returned as ordinary income, even though the gain otherwise qualified for capital gains

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21 See data presented in Treasury Studies, supra note 6, at 154.

22 Treasury Studies, supra note 6.

23 See 114 Cong. Rec. 28790 (1968).

24 See their statements before the House Comm. on Ways and Means, Tax Reform 1969, at 2007, 2016, and 2168, respectively. Many other farm organizations also supported Senator Metcalf's Bill.

25 The President's 1963 Tax Message, 88th Cong., 1st Sess. 144-45 (1963) [hereinafter cited as the President's 1963 Tax Message].

treatment under section 1231.[26] This proposal seems to have been founded on the philosophy behind sections 1245 and 1250[27] that since a deduction has been taken against ordinary income, gain thereafter realized is more than likely produced by that deduction, and simple equity requires that it be reported as ordinary income rather than capital gain.[28]

While recapture thus has a simplistic appeal to the emotions, it overlooks the value of being able to defer the payment of taxes through improper current deductions.[29] Furthermore, the appeal of recapture also lays bare its major weakness: it is accepted as being fair because a mistake has been made. The taxpayer has taken a deduction to which, in all fairness, he is not entitled. If the mistake is one of accident, recapture perhaps can be justified as a proper remedy. However, if the deduction is one which is clearly improper when taken, as is often the case in the farm area, the cure is not to recapture the prior deduction, but rather, to eliminate those provisions which allow the deduction.

Despite this logic, and in face of the substantial support that Senator Metcalf's bill received, the new Administration opted to propose EDA. Although this decision probably was based, at least in part, upon political considerations,[30] from time to time other explanations of the scuttling of the Metcalf Bill have been offered. The bill was labeled discriminatory because it allowed a taxpayer having more than one farm operation to offset profits from one against losses from the other It was thus said to prefer farm income over nonfarm income. EDA, however, offers no improvement in this regard, because the same offsetting of gains from one farm operation against losses from another

[26] Under § 1231, gains from property used in the trade or business, as defined in § 1231(b), which is held more than six months may be reported as capital gain if there is a net gain on all transactions as a whole described in that section. If there is a net loss, the losses are treated as ordinary losses.

[27] Sections 1245 and 1250 apply to some dispositions of depreciable property and contain formulae under which gain, which absent these sections would fall under § 1231 and be reported as capital gain, must be reported as ordinary income.

[28] See S. Rep. No. 1881, 87th Cong., 2nd Sess., reprinted in Internal Revenue Acts Amendatory of the 1954 Internal Revenue Code Beginning 1961 at 812.

[29] The value of mere deferral of taxes is indicated by transactions such as large prepayments of interest. Seemingly, the most abusive features of this practice were curbed by Rev. Rul. 68-643, 1968-2 Cum. Bull. 76 (1968).

[30] Even though his support was bipartisan, Senator Metcalf's approach had become somewhat "Democratic" when the Johnson Administration's Treasury Studies had suggested a very similar technique. Furthermore, the vast bulk of President Nixon's tax program was merely a re-write, sometimes with a new wrinkle or two, of parts of the Treasury Studies, and undoubtedly there was some desire to differentiate at least part of the President's proposals from those appearing in Treasury Studies. Here was a highly visible area where a change could be made. Also, the Metcalf plan had aroused considerable opposition, and by not supporting it, the Treasury could appear somewhat responsive to the concerns of those opposed to Senator Metcalf's Bill.

farm operation occurs under it.[81] A further argument was made that the Metcalf approach might arbitrarily deny deduction of economic losses. EDA was regarded as being better because it waited until there was gain to have any effect at all. This claim is somewhat misleading because an economic loss was deductible under the Metcalf Bill if the farmer used the accounting method prescribed in the bill, that is, that applicable under accepted accounting principles.[82] Thus, an economic loss would have been denied deduction only if the taxpayer ascertained that retention of the cash basis method of accounting was worth more than the deduction. Certainly a taxpayer who foregoes his loss to retain the benefit of cash accounting merely supplies the linchpin for the assertion that cash accounting is much too generous. At the very least, one cannot waste many tears on his plight.

The excess deductions account thus became the major plank in the farm aspects of the tax program. As originally proposed, it would have required all farm losses to be entered into the EDA account to the extent they exceeded $5,000 in any one year. It emerged from the House Committee on Ways and Means, however, in quite different form.[83] There was to be no addition to the EDA account except to the extent that the farm loss exceeded $25,000, and this addition was made only if the taxpayer had nonfarm adjusted gross income in excess of $50,000. Thus, by the time the proposal was in bill form it had been so seriously weakened as to be rendered wholly ineffective. It was enacted by the House in this form.[84]

[81] See Davenport, supra note 6, at 29.

[82] S. 500, 91st Cong., 1st Sess. (1969).

[83] H.R. Rep. No. 91-413, 91st Cong., 1st Sess., pt. 1, at 66-68 (1969).

[84] See 115 Cong. Rec. H7151 (daily ed. Aug. 7, 1969). Responsibility for the emasculation of EDA is difficult to assign. First, however, we should note that in its original form, it had only one proponent, the Treasury Department. Those who desired some change had generally endorsed Senator Metcalf's proposal. Thus, EDA had few defenders, and quite clearly there was considerable opposition to any change in the tax law. The injection of EDA made it much more difficult, probably fatally difficult, for those desiring effective action to close ranks and concentrate on the opposition to reform. EDA made it a three-way contest, and thereby handed the advantage over to the opponents of any reform. This opposition did not immediately show itself. At the time of the hearings before the Ways and Means Committee on March 10, 1969, the opposition appeared to be much the same as that which had blocked any action in 1963, i.e., representatives of cattle raisers, includings some who syndicated breeding herds. On April 22, 1969, the President's proposals, including EDA, were made public. In August, the House passed H.R. 13270 containing the EDA proposal, and at the time of the hearings before the Senate Finance Committee on September 22 and 29, 1969, these opposition forces had been considerably augmented by representatives of horse breeders—including one governor, two former senators, one former governor, a college president, one commonwealth, and others.

Although representatives of the horse industry had not appeared at the hearing before the Ways and Means Committee in March, its representatives apparently had made their case effectively because the provision which requires horse racing to be treated as a part of horse raising if the taxpayer engaged in both was contained in the bill as

In the Senate, the horse raisers joined forces with the cattle industry to forecast financial chaos if the farm tax laws were changed. After hearings, however, the Finance Committee rejected EDA and inserted a provision which would have limited the deductibility of farm losses.[35] While this was also overly liberal, it at least was a step in the right direction. In conference, however, the House Conferees prevailed, and EDA became part of the 1969 Tax Reform Act.

III. The Provisions of the Act

Subtitle B of Title II of the Tax Reform Act of 1969 is devoted to farm losses, etc. The *et cetera* is far broader than one would expect, and there are six provisions which deal with varying aspects of the farm loss and other problems. This welter of legislation might lead one to conclude that the problem to be handled was complex. But, as outlined above, the problem is simple: *the tax law permits premature deduction of capital costs and confers capital gain on some of the income so produced.* This simplicity somehow gets lost in the maze of provisions which Congress enacted. Indeed, the major difficulty in discussing "farm tax reform" enacted by Congress is that one must not permit the complexity and diversity to obscure the central thrust of the reform. With this goal in mind, the discussion below is separated into two parts, one discussing all of the provisions except the excess deductions account, and one devoted solely to the excess deductions account.

A. *Thrashing About the Problem: Miscellaneous Provisions*

1. *The Depreciation Recapture Provision*

When Section 1245 was added to the Internal Revenue Code in 1962, livestock was specifically excluded from the definition of Section

it came from Ways and Means. This is a favorable provision because many large racing stables have racing winnings, but at the same time, due to the farm accounting rules, show tax losses, but not true economic losses, from the breeding operation. Thus, the breeding loss will be diminished by the racing winnings, and only the balance will be available to enter into EDA. Although many racing stables appear to operate at a true loss, the pattern described above is applicable to most large racing stables that are also engaged in breeding. See note 66 infra. Since the horse breeders were able to gain this concession, it seems likely they also had some influence in shaping EDA within the committee. It also seems likely that Congressman John Watts of Kentucky, the third ranking Democrat on the Committee, was in a position to be a strong advocate of their position. In any event when EDA as proposed by the President was considered by Ways and Means, it was first amended to be applicable only to so much of the farm loss as exceeded $25,000 and then only if the nonfarm income was in excess of $50,000. One can only surmise that an amendment of this nature was strongly supported by both the horse raising and the cattle raising industries. Following this amendment, on a motion made by Representative Watts, even this weakened version of EDA was rejected by Ways and Means. Subsequently, with the switch of a single vote, EDA was reconsidered and made a part of the bill.

[35] S. Rep. No. 552, 91st Cong., 1st Sess. 97 (1969).

1245 property.[36] At the same time, the investment credit was denied for the purchase price of livestock.[37] Section 212 of the Act corrects this omission by including livestock under Section 1245 of the Code.[38]

Since most livestock is not depreciated,[39] this amendment will not have widespread application. Despite the narrowness of impact, it seems generally correct to bring livestock to a parity with other personal property. Furthermore, despite the doubtful legality of the practice,[40] there were some syndications of breeding herds which relied in large part on unrealistic depreciation deductions followed by a realization of capital gains.[41]

2. *Holding Period*

Section 212(b)(1) of the Act amends Section 1231(b)(3) of the Code. Under prior law, draft, breeding, and dairy livestock could qualify as property used in the trade or business only if held by the taxpayer for 12 months or more. As amended, cattle and horses will qualify only if held 24 months or more from date of acquisition. All other livestock would continue to qualify as property used in the trade or business if held for draft, breeding, dairy or sporting purposes for more than 12 months from the date of acquisition. As with the present law, livestock does not include poultry.

The purpose of this provision is to deny capital gains treatment to a substantial amount of the sales proceeds of cattle and race horses which formerly received capital gains treatment. The return of these proceeds as capital gain is part of, but not the major aspect of, the farm loss problem. Furthermore, it is not clear that this provision will prove effective.[42] Thus, while this amendment is a definite improve-

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36 Int. Rev. Code of 1954, § 1245(a)(3).

37 Int. Rev. Code of 1954, § 48 (a)(5).

38 The exact trade-off in the 1962 legislation is not clear. However, most livestock is raised, not purchased. Thus, the investment credit would have meant little to the industry. Similarly, § 1245 recapture, apparently affecting the same taxpayers and animals as would the credit, would have had little effect on the industry. If the industry forewent the credit to avoid recapture, elimination of the credit removed the consideration for its side of the bargain and argued strongly for the application of recapture. On the other hand, if the industry was denied the credit and then exacted lack of recapture as a recompense, simple equity would require the inclusion of livestock under § 1245 once the credit was eliminated. But does not this type of consideration suggest that § 167(f) should also apply to livestock?

39 Most livestock has no basis because it has been raised by the taxpayer and the costs of raising were deducted. In cases where livestock has been purchased or the raising costs have been capitalized, there is a basis which may be depreciated.

40 See Davenport, supra note 6, at 10 n. 27(d).

41 See, e.g., the offering brochures of Black Watch Farms, Inc., Wappinger Falls, New York, discussed in the Wall Street Journal, March 21, 1969, at 2.

42 For example, it seems likely that a good part of the sales of raised horses under two years of age is now reported as ordinary income. Note also that Treas. Reg. § 1.1012-1(c)(1) (1969) requires that shares of stock not otherwise identifiable be costed out on

ment, it does not in any way handle the farm loss problem. The truth of this assertion is explored later.

3. *Like-Kind Exchanges*

Section 1031 was amended to provide that livestock of different sexes is not property of a like kind.[43] Although such a provision was not in the House bill, the problem presented was discussed at length in the House Report.[44] The committee said:

> The importance of [the exchange] arises from the fact that ordinarily the ratio of males to females in a calf crop is approximately 50-50. Since few males are normally retained in a typical cattle operation, the remaining male calves are castrated and sold as steers at ordinary income rates. If a tax-free trade of male calves for female calves were allowed, a breeding herd of females could be built up more quickly without tax consequences.[45]

While the trading practice undoubtedly existed and was one of the selling points in some cattle operations, the amount of income deferred by this technique would not seem so great as to warrant the statutory amendment. Certainly, the committee believed that the law did not exempt the transaction, and even fairly reckless tax lawyers (never mind very cautious ones) probably would not have advised to the contrary. Thus, the statement in the report seemingly would have sufficed even though the Internal Revenue Service had not published a ruling to that effect.[46]

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a first-in-first-out rule. If the same rule were applied to cattle which may not be identified (and the livestock interests may claim that for animals two years of age or older identification is impossible), there would be little if any improvement in the reporting of sales proceeds as capital gains. (See Treas. Reg. § 1.1223-1(i) (1957) stating that the basis regulations of § 1.1012 apply in determining the holding period in this case.) Indeed, this may be a backward step because animals up to two years old may be identified, at least by age group. Hence, the holding period could at least be determined on a group basis. If animals two years of age or older may not be identified, will not the first-in-first-out argument be difficult to resist?

43 Section 212(c) of the Act.

44 H.R. Rep. No. 91-413, 91st Cong., 1st Sess., pt. 1, at 66 (1969).

45 Id.

46 Griffith and Joy, What the Act Does to the Farmer: Farm Parity or Class Discrimination?, 23 The Tax Lawyer 495 (1970), appear to criticize this provision because it taxes an exchange of a bull for a cow while continuing to permit deferral under § 1031 of an exchange of a farm for an oil well. This criticism may merely be one directed at overly broad drafting, or it may be one directed at allowing the farm to be exchanged for the oil well without tax consequences. This author thinks the first was intended. While the provision is perhaps broader than the problem, it is likely that the greatest number of exchanges affected will be those which Congress intended to reach, i.e., the exchange of a female calf for a male calf.

4. *Crop Insurance Proceeds*

Section 215 of the Act permits a cash basis taxpayer who receives insurance proceeds as a result of the destruction of a crop to include such proceeds in income for the taxable year following the year of destruction or damage, if he can establish that under his usual accounting method he would have reported the income from the crop in the later year. This amendment apparently will not affect many taxpayers even though it departs widely from the concept that the tax should be levied on money in hand when the money is received. Presumably, its purpose is to prevent the telescoping of two years of income into the year in which a crop is damaged, and in which proceeds from the prior years were also received. One need only note that the taxpayer does have the money in hand, and that the telescoping of the income is not all that serious under the averaging provisions of the Code,[47] particularly as liberalized by the Act.[48] Section 215 appears merely to be an unwarranted departure from the annual accounting concept, and as such is difficult to justify.

5. *Repeal of Section 270—The Hobby Loss Provision*

Section 270, prior to amendment by the 1969 Act, was a poorly designed section. It required a recomputation of income if a trade or business operated by an individual showed a $50,000 loss in each of five consecutive years. For this purpose, the size of the loss was computed without regard to certain "specially treated" deductions.[49] In the recomputation, $50,000 of the loss so computed was allowed, but all of the specially treated deductions remained fully deductible.

The Treasury offered some changes to section 270 which would have tightened it considerably.[50] Its operation even after those amendments would have continued to be erratic, however, and would have continued to apply regardless of the economic loss. The House Ways and Means Committee, apparently recognizing these weaknesses, rejected the Treasury's proposals and instead would have eliminated prior section 270 and replaced it with a new concept. Under the rule adopted by the House,[51] a taxpayer would not have been allowed to deduct losses or deductions attributable to or arising

[47] Int. Rev. Code of 1954, §§ 1301-1304.

[48] See § 311 of the Act.

[49] Int. Rev. Code of 1954, § 270(b).

[50] Tax Reform 1969, at 5183-186, 5425-426.

[51] H.R. Rep. No. 91-413, 91st Cong., 1st Sess., pt. 1, at 71 (1969).

[52] This apparently would have settled the dispute whether the taxpayer needed to be a reasonable person in expecting a profit in order to prove a business motive. The Ninth Circuit had stated, if not held, he need not be, in Mercer v. Commissioner, 376 F.2d 708, 710-11 (9th Cir. 1967).

from an activity carried on by him if the activity was not operated with a *reasonable*[52] expectation of realizing a profit. Whether there was a *reasonable* expectation of realizing a profit was a determination to be made on the basis of all of the facts and circumstances, but the Treasury Department in every case was to be assisted by a presumption. If the activity was carried on at a loss in excess of $25,000 in three out of five years, then, unless the taxpayer could prove to the contrary, the activity would be deemed to be carried on without a *reasonable* expectation of realizing a profit, and thus would be subject to the limitation.[53] While such a presumption could be criticized as unwise because it could penalize a number of businesses where true economic losses resulted, it at least could not be criticized on the grounds that it was creating a haven for a taxpayer's hobby operations. Before Congress was through, however, this latter criticism was also valid.

In apparent solicitude for taxpayers who suffered an unusual number of tax losses, the Senate reversed the presumption, and the Senate version of the bill prevailed in conference. The Act added a new Section 183 to the Code. It provides that deductions attributable to any activity not engaged in for profit, whether or not it involves farming, are allowable only to the extent of (1) deductions allowable without regard to profit motive, plus (2) the amount remaining after gross income derived from such activity has been reduced by the deductions allowed under (1). The category of deductions allowable without regard to profit motive presumably includes such deductions as taxes, interest, casualty losses and bad debts. If there is doubt about the profit-seeking motives, the *taxpayer* is aided by a presumption. If in any two or more taxable years in a period of five consecutive years the gross income from the activity exceeds the deductions attributable to such activity, then unless the *government* can show to the contrary, there is a presumption of profit seeking. For businesses consisting in major part of breeding, training, showing or racing of horses, the five-year period is extended to seven years. This liberality presents discrimination in favor of an industry which is allegedly particularly hazardous, but which would not appear to have either a high social or economic claim for special treatment.

While the Treasury previously had been largely unsuccessful in winning the hobby loss cases, this new tool will impose an even heavier burden upon it. Few taxpayers, whether in the farming business or any other, will fail to show at least one dollar of net income in 40 percent of their years. Furthermore, so long as the cash method of accounting is permitted for farm income and expenses, the tax-

[53] S. Rep. No. 552, 91st Cong., 1st Sess. 104-05 (1969).

payer can defer either the expenses or the income of one year to a later year and get a doubling-up effect. On the other hand, the taxpayer can anticipate expenses or income. If necessary, he can combine into a single year the deferred income of prior years, the current income, and anticipated future income while deferring all current expenses. Similar liberalities are available for expenses. It is thus nearly inconceivable that a farmer using the cash method of accounting cannot show at least one dollar profit in some two out of five consecutive taxable years. Thus, so long as the liberal cash accounting rules are permitted, each farm hobby loss controversy may be brought into the area covered by this proposal. Perhaps, on the whole, this effect will be beneficial. Efforts which are today devoted to auditing true hobby farmers are usually followed by losses in court. With an even greater burden imposed on the government, the Internal Revenue Service is likely to forego further hobby audits, and the effort thus conserved will be more productively spent in other endeavors. The necessity of finding such a justification for the hobby loss provision is, however, a very sad commentary on a tax reform act.[54]

6. *Gain from Disposition of Farm Land*

If the excess deductions account hereinafter described does not apply to the disposition of farm land, if the taxpayer has enjoyed deductions under sections 175 and 182[55] with respect to farm land, and if sale occurs before the taxpayer has held the land ten years, a percentage of these deductions is to be recaptured upon any disposition of the farm land.[56] Through the first five years, 100 percent of any deductions is to be recaptured. The percentage declines at the rate of 20 percent per year thereafter until such time as the land has been held ten years or more, when none of the deductions is to be recaptured. The ten-year period is measured by the holding period

[54] Neither is the hobby loss provision a model of clarity. Does "profit" mean a tax profit or an economic profit? Is the deduction for capital gains attributable to the activity? McDonald v. Commissioner, 214 F.2d 341 (2nd Cir. 1954), on remand, 23 T.C. 1091 (1955), acq., 1956-1 Cum. Bull. 4, holds that it is not, and the deduction would be allowable while including the whole gain in gross income for determining whether there is a profit. What is an activity? What is a "major part" of an activity for determining whether the five-year period applies? How is intent to be determined? Are years subsequent to the year in question to be counted? If there is a profit? If there is a loss? How does the presumption apply to years before 1970? Some of these questions are discussed in Diamond and Horne, Hobby Losses; Miscellaneous Individual and Corporate Problems, 23 The Tax Lawyer 609, 610-13 (1970).

[55] Section 175 allows a deduction for certain soil and water conservation expenses which are capital expenditures, and which would not be depreciable or otherwise deductible but for this section. Section 182 allows a very limited deduction for certain land clearing expenses.

[56] See § 214 of the Act which adds § 1252 to the Code, and in particular § 1252(a)(3).

of the land, not the period following the incurring of the expenditure under sections 175 or 182. For example, if land has been held for four years and ten months and if section 175 expenses were incurred at acquisition or soon thereafter, such expenses will be recaptured as ordinary income to the extent there is gain on sale of the land. On the other hand, if land has been held ten years, and if large section 175 expenses are incurred in anticipation of sale, the expenses are not recaptured on the sale of the land.

Little can be said in favor of this provision. It is another example of permitting the evil in the first place, and subsequently attempting to correct it by a recapture proposal. If the activity to be encouraged from the allowance of the deductions under sections 175 and 182 is actually beneficial, it is difficult to understand the theory behind recapturing these deductions if the land thus benefitted is sold within ten years of acquisition without reference to when the "evil" expenses were incurred. Provisions such as this, however, do serve one purpose. They reveal the fragile ground on which the entire notion of recapture is built.

7. *Capitalization of Certain Costs*

Although the farming industry in general will be largely unaffected by the new Act, the citrus industry appears to have had a partially correct, but highly discriminatory, rule prescribed for it. Section 216 of the Act adds a new Section 278 to the Internal Revenue Code. The section requires that all expenses incurred in connection with a citrus grove prior to the close of the fourth taxable year, beginning with the year in which the grove was planted, be charged to capital account. Plantings resulting from trees lost or damaged by reason of freeze, drought, disease, pest or casualty, or which were planted or replanted prior to the enactment of the section, are excepted from the capitalization rules.[57]

A bill containing somewhat similar provisions[58] was introduced as early as the 89th Congress, apparently through the efforts of the established Florida citrus growers, to deny new growers the advantage of writing off capital costs, a benefit of which the established growers presumably had availed themselves.

Since capitalization of development costs is a proper rule, one might think that the provision should be beyond reproach. Unfor-

57 This may result in a double deduction in the year in which the loss occurs. The capitalized cost of a grove damaged by freeze, etc. will presumably be allowable. In addition, development costs after the new planting (but not planting costs) will be deductible. See Griffith and Joy, supra note 46.

58 H.R. 9454, 89th Cong., 1st Sess. (1965), introduced by Representative Haley of Florida.

tunately, for several reasons it is not. First, it is not altogether clear what is encompassed within the meaning of citrus.[59] Also, since the preproduction cycle of all citrus is not uniform,[60] some citrus growers will be allowed to continue deducting the portion of the preproduction costs which extend beyond the fourth taxable year, including the year of planting. In addition to discriminating among various kinds of citrus, the blatant discrimination against citrus as compared to other kinds of groves, orchards and vineyards is indefensible. There is no reason why the grower of peach trees, English walnut trees or grapes should be preferred over the grower of citrus. In addition, there is no reason to treat the citrus farmer more harshly than the cattle farmer. One can only hope that the principle embodied in this provision will ultimately become the touchstone of farm tax accounting, and that proper capitalization will be required in all areas of the farming industry.

This brings us to the major provision in the farm loss area.

B. *Perpetuation of the Problem: The Excess Deductions Account*

The excess deductions account, the major provision of the 1969 Act, was first proposed in 1963,[61] but never emerged from any of the tax writing committees. In the form finally adopted in 1969, it is complex, almost beyond comprehension. In addition, it is a wholly ineffective measure which, unfortunately, does not even lay a foundation for further reform. Despite these objections, however, Congress adopted it.

Section 211 of the Act adds a new Section 1251 to the Code. It provides for the inclusion in gross income, as ordinary income, of gain[62] from the disposition of farm recapture property disposed of during taxable years beginning after December 31, 1969. The provision applies only if, and to the extent that there is either (a) "farm net loss" for the year, or (b) a balance in the excess deductions account

[59] For example, are kumquats within the citrus family? The Encyclopedia Brittanica, vol. 13, at 508 (1966 ed.) states kumquats are of the Fortunella genus and were formerly placed under citrus japonica. Does this mean that kumquats are no longer citrus but something else? One might note that it is a strange provision of the tax law which drives one to the encyclopedia to determine whether an expenditure is deductible. But see proposed regulations which define citrus as belonging to the rue family. See proposed regs. § 1.278-1(a)(2)(ii) promulgated Nov. 11, 1970.

[60] See Reed, An Analysis of Orchard Development Costs, (University of California Agricultural Extension Mimeo, 1968) at 1, where it is estimated five to seven years depending on the kind of citrus involved.

[61] See The President's 1963 Tax Message, supra note 25, at 144-45.

[62] In the case of sales, exchanges, and involuntary conversions, gain is proper terminology. Gain may not, of course, be recognized (arguably not realized) on other dispositions. In those cases, the amount treated as ordinary income is the excess of fair market value over adjusted basis. The section thus is patterned on §§ 1245 and 1250, and the dispositions excepted from the recognition rule in those sections are also dealt with in § 1251.

at the end of the taxable year after reducing the amount in the account at the beginning of the year for any "farm net income" for the year.[63]

A "farm net loss"[64] is the amount by which current deductions directions directly connected with the carrying on of the trade or business of farming exceed the gross income currently derived from the trade or business of farming for the year. Gains and losses from the disposition of farm property defined in section 1231 are not taken into account for the purpose of computing the farm net loss. Similarly, "farm net income"[65] is defined as the amount by which current gross income attributable to farming exceeds the current deductions attributable to farming.[66]

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[63] The operations of EDA may perhaps be better understood by the use of an example. The one which follows is Example 1 of the Treasury's proposals (See Tax Reform 1969, at 5179-180) adapted to reflect the differences between the Act and the Treasury proposal.

The taxpayer, a corporate executive, earns a salary of $75,000 each year, and owns a farm with respect to which, in 1970, ordinary deductions exceed ordinary income by $40,000. In 1971, the farm produces net ordinary income of $5,000 and, in addition, a prize bull, which has a zero basis, is sold for $1,500 in a sale which would qualify for capital gains treatment unless EDA changes that result. In 1972, the farm shows a net loss of $3,500. In 1973, his ordinary farm income just equals farm expense, but he sells breeding livestock which he held more than two years, valued at $12,500 but without any basis.

The taxpayer's EDA would be computed as follows:

EDA

Year	Additions	Subtractions	Balance
1970	$15,000		$15,000
1971	0	$6,500	8,500
1972	0	0	
1973		8,500	0

This chart summarizes the following transactions: In 1970, the taxpayer enters $15,000 in the excess deductions account (the excess of the $40,000 loss over the $25,000 floor). In 1971, the EDA is reduced by the net ordinary income from farming ($5,000). Since the amount in the EDA is larger than the capital gain on the sale of the bull, the $1,500 income on the sale of the bull is treated as ordinary income. The EDA accordingly is also reduced by the amount of capital gains treated as ordinary income ($1,500). At the end of 1971, the EDA is $8,500. The loss in 1972 does not add to the account, however, because the loss is less than $25,000. Thus, the account remains at $8,500. When the livestock is sold in 1973, only $8,500 of the $12,500 gain is treated as ordinary income, and the balance of the gain is treated as capital gain.

It is interesting to note that if farm income is realized before there is a loss, the previous farm income does not prevent later losses from being entered in EDA. However, net farm income realized after a loss will insulate the effect of that loss by eliminating an equal amount in the EDA. Such differing tax treatment, depending wholly on timing of income and expense, is at least questionable policy.

[64] Section 211(a) of the Act.

[65] Id.

[66] In both cases, the business of farming includes the racing of horses if the taxpayer is also engaged in the raising of horses. This would appear to be another unwise concession to the horse racing industry. Has this favoritism converted the "Sport of Kings"

An addition to an individual taxpayer's excess deductions account is made only in years in which the taxpayer has *nonfarm adjusted gross income* in excess of $50,000.[67] The amount added to the account in those years is only that portion of the net farm loss which exceeds $25,000.[68] The amount of the EDA at a given moment is the cumulative amount of the net farm losses of other years to the extent they exceeded $25,000 in any year in which the taxpayer had $50,000 of nonfarm adjusted gross income. Any balance in the account must be reduced by three amounts. It is first reduced by the amount of net farm income for the year. Second, there appears to be a statutory adoption of the so-called tax benefit rule.[69] The balance in the EDA is reduced by any deduction which did not yield a tax benefit (i.e., a reduction in tax) in the current or preceding tax year. Finally, the amount in the account is reduced by the amount of any gain for the taxable year which is converted from capital gain to ordinary income by reason of the EDA. This last reduction requires further explanation, that is, when does a conversion from capital gain to ordinary income occur?

Gain which may be converted is gain realized on "farm recapture property." Farm recapture property is property defined in section 1231(b)(1), (3) or (4), which is or has been used in the trade or business of farming by the taxpayer, or by the transferor to the taxpayer in a transaction under which some part of the excess deductions account is transferred to the transferee. Property is also included as

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into the "King of Sports"—at least taxwise? Some may argue that the aggregating of racing and raising of horses will not always work in favor of taxpayers because racing very often results in large losses which will increase the farm net loss. Obviously, this result may occur in a particular case. The overall pattern appears to the contrary, however. In most cases, racing is profitable to most taxpayers who are also heavily engaged in raising. In the majority of unprofitable racing cases, the horses appear to have been purchased horses. The consequence is that tax losses from raising horses will be offset against racing earnings and will not be available to convert gains realized on the sale of horses to ordinary income. This comment is not meant to imply that horse raising tax losses are in the usual case economic losses.

[67] Nonfarm adjusted gross income is adjusted gross income computed without regard to income or deductions attributable to farming.

[68] In the case of a husband and wife who file separate returns, each of these figures is reduced by one-half respectively. All corporate taxpayers (with the exception of a subchapter S corporation which has no shareholder who has a farm loss of his own) enter the entire amount of the loss into the excess deductions account even if there is no other income. If no shareholder of a subchapter S corporation has a farm loss of his own, the corporation is allowed the benefit of the individual taxpayer rules, i.e., additions are made to EDA only if nonfarm income is $50,000, and only to the extent the loss exceeds $25,000. See § 211 of the Act.

[69] See Dobson v. Commissioner, 320 U.S. 489 (1943). Under the "tax benefit" rule, later recovery of an item previously deducted is included in income only if the deduction resulted in lowering the tax base, thereby lowering the amount of tax, and thereby yielding a tax benefit.

farm recapture property if its basis is determined by reference to the basis of farm recapture property. For example, if farm recapture property is exchanged tax free for other property under section 1031,[70] the property received in the exchange has a basis determined by reference to the basis of the farm recapture property given up, and the property received thus is farm recapture property.

1. *Special Transfers*

As with sections 1245 and 1250,[71] section 1251 is generally activated by any disposition of property. As with those sections, however, certain dispositions are excepted from this general rule. Excepted transfers present a problem because each exception provides an opportunity to separate the farm recapture property from the amount in the EDA attributable to that property. If such separation occurs, subsequent sale of the property will frustrate the purpose of the statute because absent an EDA, the transferee probably will report the sales proceeds as capital gain. For example, if a farmer raised a cow to maturity, incurring $250 of costs which he added to EDA, his sale of the cow at, say $300, would yield $250 of ordinary income and possibly $50 of capital gain. If, however, he gives the cow to his son, we can assume that the sale proceeds will be treated as $300 of capital gain unless the statute has a special provision transferring some of the father's EDA to the son. The gift then would permit the $250 of costs, deducted by the father, to be converted to capital gain in the son's hands.

The same problem was faced when section 1245 and section 1250 were drafted. In certain selected transfers under those sections, gain is not recognized, but the potential recapture (i.e., the amount which would be treated as ordinary income if sold) carries over to the transferee. Since EDA was also a "recapture" provision, logic seemed to dictate the same treatment for farm recapture property as is prescribed for sections 1245 and 1250. This logic is deceptive, however. First, the possibility of abuse resulting from the deduction of farm losses is greater than the abuse in many depreciation cases.[72] Second,

[70] Whether or not such an exchange is tax free is discussed below.

[71] Section 1245 "recaptures" excessive depreciation on most personal property. Section 1250 does the same to a lesser extent for depreciation on real estate.

[72] See Davenport, A Bountiful Tax Harvest, 48 Texas L. Rev. 1 (1969) at 36-37:

> Except for a few industries such as the leasing of automobiles, most depreciable property subject to section 1245 does not by its very operation constantly produce merchandise for transfer, even though the merchandise so produced has also been used in the trade or business. The process of culling the livestock crop does produce this merchandise. The very nature of the business makes it inevitable that there will be substantial property that must be transferred. In most section 1245 cases, the property is either abandoned or transferred at nominal value. It may be argued that recapture is satisfactory in these cases but that it is

in the case of depreciable property, whether personal or real, the regulations[73] provide a means by which the potential recapture amount (i.e., the reserve for depreciation) attributable to each item of property may be computed. Although this computation is sometimes complex in the extreme, such as when the item has been removed from a classified or composite account, the amount of prior deductions taken with respect to any item of property and the amount of potential ordinary income inhering in it can be precisely computed whether the property is in the hands of the original owner or a transferee. In the case of farm recapture properties, such as a herd of cattle, the amount of the potential recapture may be impossible to establish because there is no means (given the bookkeeping practices tolerated for farmers) by which to determine the amount of deductions which has previously been taken with respect to a particular animal. Thus, the amount of potential recapture with respect to farm property cannot be satisfactorily computed in some cases. Despite these differences, a decision was made to except from recapture under section 1251 the same transfers that were excepted from sections 1245 and 1250. These differences, however, were such that they had to be recognized. The consequence is that the rules for excepted transfers of farm property differ substantially from the rules devised to cover the exceptions to sections 1245 and 1250.

With respect to each of the excepted transfers discussed below, two problems arise. The first is whether any gain should be recognized. Obviously, if gain is to be recognized, it will be ordinary income if the property transferred is "farm recapture property," and if the transferor has a balance in his EDA. The second problem arises only if some of the gain is not recognized. If gain is not recognized, there is the possibility of frustrating the statute unless the ordinary income potential also carries over to the transferee so that his gain will not be reported as capital gain. These problems were handled in the variety of ways discussed below.

a. *Gifts.*[74] Ordinary income is not recognized on the disposition of farm recapture property by gift. A part or all of the transferor's EDA may be transferred to the donee, however. If in any one year (i.e., any 12 months—not necessarily a taxable year) the transferor makes gifts of farm recapture properties which carry at least 25 percent of his total "potential gain" on farm recapture property held by the donor immediately prior to the first of such gifts, then a pro-rata

unsatisfactory when transfers are inevitable and each transfer presents a substantial tax avoidance opportunity. Thus the abuse possibilities are worse in this case, and recapture just is not adequate to handle the problem.

[73] See Treas. Reg. §§ 1.167(a)-7, -8 (1956).

[74] Section 211(a)(5)(B) of the Act.

part of the excess deductions account shall be transferred to the donee of such farm recapture property. "Potential gain" is the amount by which the fair market value of any farm recapture property exceeds its adjusted basis. In the case of land, in order to preserve the special rules relating to the recapture of only the section 175 and 182 deductions on land,[75] potential gain includes only those deductions which have been taken in the current taxable year and the preceding four taxable years.

b. *Transfers at Death.*[76] Except to the extent that income in respect to a decedent is realized upon a transfer at death, there is no realization of ordinary income upon the transfer by decedent to his estate. Apparently, there is no transfer of EDA either. Thus, death seems to offer one means of avoiding EDA. In view, however, of the general ineffectiveness of EDA and of the other routes available to escape EDA, this author does not recommend death as an avoidance technique.

c. *Corporate Transactions.*[77] The relevant transfers here consist of (1) transfers to corporations, (2) transfers by corporations in liquidations or redemptions, and (3) reorganization transfers, including those falling under sections 371(a) and 374 (a).

If farm recapture property is transferred to a corporation in a transfer under section 351 and has a carryover basis in the hands of the corporation, the EDA provision of the 1969 Act does not require gain to be recognized on the transfer. If, however, gain is recognized apart from EDA, it is treated as ordinary income to the extent of the balance in the transferor's EDA. Generally speaking then, tax free incorporations are expected from the recapture provisions.

Since the section 351 transfer does not result in ordinary income, the transferor's EDA will be unchanged by reason of the transfer. Also there is a tax avoidance possibility, as pointed out above, because the transferee may have no EDA. This possibility could have been eliminated by transferring a pro-rata part of the EDA to the corporation. The decision was otherwise, however, and the transferor's EDA is not diminished by the transfer. Rather the stock and securities received by the transferor become farm recapture property to the extent attributable to the fair market value of farm recapture property[78]

[75] See note 55 supra.

[76] Section 211(a) of the Act.

[77] Id.

[78] Id. In the case of land, if the total of the adjusted basis of the land and the "potential gain" on the land is less than the fair market value, the stock and securities are so treated only to the extent of the total of these two items. At first blush, one might think that in such case only the potential gain should be treated as property. The statute prescribes a proper rule, however. Suppose a case of property having a basis of $10 and

contributed to the corporation by the transferor. The purpose is to require recognition of ordinary income upon disposition of the stock or securities by the transferor, just as a disposition of the farm recapture property transferred to the corporation would have required recognition of ordinary income.[79]

Since the EDA does not carry over to the transferee corporation in such cases, the corporation may be able to sell the transferred property at capital gains rates after the transfer.[80] If a subchapter S election were in effect, presumably the capital gains so realized would be taxed as capital gains to the shareholder.[81]

Transfers in liquidation take a carryover basis under section 332. If the liquidation falls under section 332, the transferor will be treated as having ordinary income only if gain is recognized apart from section 1251, and then only to the extent of the lower of the recognized gain or the EDA balance.

The rules for reorganizations are similar to those for liquidations under section 332. Ordinary income is imputed only to the extent of the lower of gain recognized apart from section 1251 or the balance in the transferor's EDA. Reorganizations falling under section 381[82] result in a carryover of the transferor's EDA to the transferee. There is no carryover for devisive transfers which do not come under section 381 but the stock and securities become farm recapture property. The consequence is that in corporate reorganizations where nearly all the property is transferred, the EDA balance carries over to the transferee.[83] But in other reorganizations, there is no shift of any EDA.

d. *Like-Kind Exchanges and Involuntary Conversions.*[84] The amount which a transferor must treat as ordinary income may not exceed the balance in his EDA account or the amount of gain realized. Subject to this qualification, ordinary income is the amount of gain recognized, apart from section 1251, plus the fair market value of

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a potential gain of $15. If the stock received is then sold for $35, the receipts will be treated as from farm recapture property to the extent of $25. Presumably, basis will absorb $10, ordinary income will consist of $15 (the amount of potential gain), and there will be capital gain of $10. Failure to treat basis as farm recapture property would present difficulty in allocating receipts to various portions of the property.

79 Obviously in some cases there will be an overlap between this provision and the collapsible corporation provision of § 341 of the Code.

80 It is not clear that capital gain would be realized on that sale. See Davenport, supra note 72, at 39 n. 69.

81 See § 1378 for provisions by which a subchapter S corporation is required to pay a tax on capital gains realized by it.

82 See also §§ 371(a) and 374(a).

83 Only those transactions involving all or nearly all of the transferor's assets fall under § 381.

84 Section 211(a) of the Act.

property (as to which gain is not recognized) which is not farm recapture property.[85]

e. *Partnerships.*[86] Farm recapture property raises problems with respect to partnerships (1) when the partnership disposes of such property, (2) when the partnership distributes such property to a partner, and (3) when a partner contributes farm recapture property to the partnership.

As to the first of these transactions, under section 1251 each partner takes into account separately his distributive share of the farm net losses, gains[87] from the disposition of farm recapture property, and other items.[88] Thus, the partnership is treated as a mere conduit for the purpose of adding farm losses to EDA, reducing the balance in an EDA by the amount of farm income for the year, and for realizing gains on the disposition of farm recapture property.

As to the second problem, distributions from partnerships are not dealt with directly. However, section 751(c), defining unrealized receivables, is amended to include farm recapture property and farm land subject to recapture of section 175 and 182 deductions.

As to the third problem, contributions to partnerships, the difficulties presented are those discussed at the beginning of this section on excepted transfers. First, is the contribution of farm recapture property a taxable transaction? If not, does the balance, or some part thereof, in the transferor's EDA carry over to the partnership? The second of these questions is answered negatively. The answer to the first depends on something more. Ordinarily a contribution to a partnership is a nonrecognition transaction by virtue of section 721. In a general way, this rule is continued for contributions of farm recapture property, but there is an exception. If the fair market value of the farm recapture property, contributed to the partnership, exceeds the fair market value of the partnership interest *attributable* to the farm recapture property, gain is recognized to the extent of such excess value.[89]

The apparent intent of this rule may be illustrated by an example.

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85 For example, suppose a taxpayer exchanges farm land for an office building. This is a tax free exchange under § 1031. The office building is not farm recapture property. Thus, if the taxpayer had a balance in his EDA, and if the taxpayer had incurred within the current or four preceding taxable years allowable deductions under § 175 or § 182 with respect to the farm land, the taxpayer would recognize ordinary income in the lower of (a) gain realized, (b) the amount in his EDA, (c) the deductions under § 175 and § 182, or (d) the fair market value of the office building. But even if § 1251 does not apply, § 1252, discussed below, may apply.

86 Section 211(a) of the Act.

87 One might question the effect of a disposition which does not result in gain to the partnership, e.g., a charitable contribution. Presumably, the nature of the disposition flows through to the partner.

88 Other items seemingly would include "farm net income."

89 Section 211(a) of the Act.

Assume a case where *A* transferred cattle (farm recapture property) having a $100 value but a zero basis to a partnership in which *B* transferred cash of $100 to be an equal partner. The value of *A*'s interest would be $100, and this value apparently would be attributed $50 to the cattle and $50 to cash. *A* then would realize $50 of ordinary income on the contribution because the fair market value of the farm recapture property transferred was $100 and exceeded by $50 the value of *A*'s interest in the partnership which is attributable to the cattle.[90] The cattle would have a zero basis to the partnership, and if it sold them for $100, the partnership would realize a gain of $100. Half of this gain would be passed through to *A* as a gain on farm recapture property since he accounts for these items separately. Assuming he had a balance in his EDA, this gain would be treated as ordinary income. When this $50 gain is added to the $50 gain realized at the time of contribution, *A* will have realized $100 of ordinary income with respect to the cattle. This is a proper result because the amount is equal to what *A* would have realized had he sold the cattle and contributed cash.

The foregoing may be modified by the partnership agreement. If the partnership agreement provides for an allocation to the contributing partner of gain on the contributed farm recapture property, the partnership interest shall be deemed attributable to the contributed farm recapture property. Thus, in the above example, if the partnership agreement allocated the entire gain on the cattle to *A*, the entire value of his partnership interest would have been attributable to the cattle. Since that value and the value of the cattle were equal, he would have no ordinary income on the contribution. When the cattle were sold by the partnership, the entire gain of $100 would be allocated to *A* in accordance with the partnership agreement, and he would realize the entire gain as ordinary income, assuming he had a balance in his EDA.

The obvious purpose of this provision is to require ordinary income to be recaptured at the time of contribution unless the transferring partner agrees to take the gain on the transferred farm recapture property into account when disposed of by the partnership. In short, if the transferring partner agrees to have the gain on the assets contributed by him allocated to him and taxed to him as ordinary income if and when disposed of by the partnership, then there is no gain on the transfer to the partnership. If the partnership agreement does not

[90] Under a different construction of this section one could argue that *A*'s entire interest in the partnership is attributable to the cattle because it was received in exchange for the cattle. This construction would permit the statute to be circumvented. Also, the value of *A*'s interest in the partnership is attributable to all the assets held by the partnership. Thus, the value of *A*'s interest depends in part on the cash.

so provide, the draftsmen apparently intended that the contribution itself be a disposition requiring recognition of ordinary income. Hopefully that intent will be realized.

2. *Subchapter S Corporations*[91]

Under the Act, a corporation's entire farm loss (not just the portion exceeding $25,000) is entered into the corporation's EDA even if the corporation had no nonfarm income. Thus, corporations are treated differently than individuals who enter into EDA only if that portion of the farm loss that exceeds $25,000 and only if nonfarm income exceeds $50,000. Subchapter S corporations are excepted from the general rule for corporations and instead fall under the rules for individuals, unless a shareholder has a net farm loss for the year. If a shareholder does have a net farm loss, then the general corporate rules apply.

These provisions seem to open up a wide avenue of abuse. If a cattle operation were incorporated, any losses would be incurred at the corporate level. The loss, however, would apparently be deducted under section 1374 by the shareholders as a net operating loss deduction of the corporation, not a farm net loss. The shareholder apparently would not enter any amount into his own EDA, or for that matter be treated as incurring a "farm net loss." As a result, the $25,000 loss floor and the $50,000 nonfarm floor at the corporate level would be operative, and the corporation would not enter any amount in its EDA. Once the corporation is sufficiently aged so as to avoid the collapsible provisions of section 341,[92] the taxpayer would be in a position to sell his stock in the corporation and realize capital gain upon it. The buyer, of course, could get a step up in basis by liquidating under section 334(b)(2), and the corporation apparently would not have any income on the liquidation.[93]

Another way to use this loophole would be to hold the corporate farm loss to less than $25,000 each year. Thus, if the taxpayer decided to invest $200,000 in cattle in any one year, he could do it through eight different subchapter S corporations. The extent to which the multiple corporations doctrine would curb this practice is not predictable, but it has not been a highly successful remedy for other abuses in the past.[94]

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[91] Section 531 of the Act.

[92] Aging, of course, is not the only means of avoiding § 341. The term "aging" does not imply that a mere passage of time following incorporation will be satisfactory. Rather the 70% rule of § 341(d)(2) appears to be the surest and easiest means of aging.

[93] Cf. Commissioner v. South Lake Farms, Inc., 324 F.2d 837 (9th Cir. 1963).

[94] Compare Aldon Homes, Inc., 33 T.C. 582 (1959) and Shaw Constr. Co. v. Commissioner, 323 F.2d 316 (9th Cir. 1963) with cases such as Hiawatha Home Builders,

3. *Exception for Special Accounting Methods*

Finally, one need not keep an EDA in any year in which he elects to use inventories and capitalize all capital costs.[95]

IV. Appraisal

Despite the analysis and tears already spilled over the "farm loss" problem, the 1969 Act does not handle it. One reaches this conclusion even though an act with six provisions for a problem simple in its most egregious examples would seemingly have something for everyone. In a sense, it does, even including several special provisions for horse racing. It seems appropriate now to say a few words of evaluation.

Livestock

One cannot argue with the soundness of extending the section 1245 recapture provision to livestock. Nor can one fault the extension of lives for qualification of livestock under section 1231, unless perhaps to argue that livestock should never be defined as property used in the trade or business—at least where raising costs are entirely deducted. Further discussion of this aspect is deferred for the moment.

Inc., 36 T.C. 491 (1961); Cronstroms Mfg. Co., 36 T.C. 500 (1961); Pre-Mixed Concrete, Inc., ¶ 63,301 P-H Memo T.C. (1963); and Sno-Frost, Inc., 31 T.C. 1058 (1959).

95 But even statutorily imposed adoption of proper accounting methods would not solve all the problems in the farm area. There would continue to be a need for administrative action. Commissioner v. South Lake Farms, Inc., 324 F.2d 837 (9th Cir. 1963) demonstrates one such problem. The taxpayer was an accrual basis taxpayer who shrewdly observed that under Treas. Reg. § 1.61-4(b) expenditures which would be carried as inventory costs in most businesses continue to be deducted by even accrual basis farmers. There is an income offset to the deduction only if the expenditures create an item which must be included in inventory. Growing crops probably are most nearly like goods in process inventory. As such, these costs should inventory. The law and custom has long been to the contrary. They may not be valued and included in inventory. I.T. 1368, I-1 Cum. Bull. 72 (1922); Internal Revenue Service Publication No. 225, Farmer's Tax Guide 17 (1969 ed.); Amling-De Vor Nurseries, Inc. v. United States, 139 F. Supp. 303 (N.D. Cal. 1956). Thus, if the tax year can be ended while the crops are growing, the expenses thereof may be deducted, and there will be no offsetting inventory value. A loss thus can be planned. A mere change in rulings and regulations could handle this problem. Note also that the Farmer's Tax Guide applies "the growing crops cannot be inventoried" rule only to crops which are not purchased. This limitation is not supported by the regulations or I.T. 1368, supra. However, case law seems to reach that result without specifically so stating, but relying on other provisions of the regulations. See, e.g., W. Cleve Stokes, 22 T.C. 415 (1954), acq. 1954-2 Cum. Bull. 5. Except for alleged ease of determining proper inventory values, there is little reason to distinguish between purchased and planted growing crops. It is believed that a similar distinction is made in cases of chicken. It appears that Internal Revenue Service practice requires a purchase of fertilized eggs, even up to the instant before birth, to be treated as a raising cost which may be currently deducted. If, however, the chick cracks the shell and sticks his head out before purchase, the cost must be capitalized as a cost of purchased animals.

Hobby Losses

The new "hobby loss" provisions are a distinct step to the rear. A showing of one dollar of income in any two of a five-year period places on the government the burden of proving that the taxpayer did not expect to realize a profit from his activities which are alleged to be a business. Since most of the facts which would prove such an intention are within the control of the taxpayer, he should not be relieved of his burden of proof. Furthermore, the existence of so little a profit really has no probative value in demonstrating the taxpayer's intent. Thus, the presumption is both unduly generous and logically unsound. Furthermore, the provision is not limited solely to farming, but rather applies to all activities engaged in by a taxpayer. Such broad sweep legislation should not have been considered nor enacted as part of a package supposedly directed toward the much narrower "farm loss" problem. Finally, the provision is far from free of ambiguity.[96] It thus appears unwise when viewed from almost any stance.

Farm Land Recapture

The provision recapturing section 175 and 182 expenses again indicates the ambivalence with which Congress apparently views its own solemn acts. It gives the subsidy by permitting capital costs to be deducted. The subsidy, however, is removed if the taxpayer sells the land within ten years of purchase. Thus, Congress seems to be saying that the activity encouraged by the current deduction of costs is good only if the taxpayer incurring such costs has had the land a long time, or is willing to keep the land for a long time (ten years) after purchase. The period of retention is not related to the "good" done and may reward the owner who had the land long enough to let it run down under his use. Also the provision is a "recapture" proposal, and as discussed below, the wisdom of recapture is certainly questionable. If there is a problem it should be dealt with directly rather than through recapture.

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[96] For example, does gross income from an activity include the deducted one-half of capital gains which are not taxed? James McDonald, 23 T.C. 1052 (1955), would include deducted capital gains on gross income. See also Tax Reform 1969, 5184 and Rev. Rul. 56-191, 1956-1 Cum. Bull. 636 modifying Rev. Rul. 219, 1953-2 Cum. Bull. 181, as modified by Rev. Rul. 57-727, 1957-2 Cum. Bull. 222. The same group of authorities also hold that the capital gains deduction is not a deduction attributable to the activity which produced the capital gain. If these authorities remain, one need not even show a taxable profit to raise the presumption in his defense. Thus, if gross income consists of capital gain of $100, the income is in excess of deductions in such year if all deductions attributable to the gains other than the § 1202 deduction are not more than $99.99. This would result in a one cent excess of gross income over deductions even though reported as a $49.99 loss for tax purposes. Two such years in any five-year period raises the favorable presumption. Could Congress have so intended? See also note 39 supra.

Crop Insurance Proceeds

The provision giving relief under certain circumstances where a crop is damaged or destroyed has little to recommend it. It is limited to cash basis taxpayers and is, therefore, discriminatory. It erodes the concept that the tax should be paid at least as early as the end of the year in which the cash is received in hand. Its avowed purpose is, of course, to alleviate the full impact of the progressive tax rate schedule on the inclusion of two years income in one year, but this impact is already substantially lessened by averaging. Thus, the justification for this provision hangs by a thin thread. On balance, one may be inclined to withhold criticism because the provision will affect so few taxpayers, but surely this is a less than persuasive argument for supporting it.

Citrus

The rule adopted for citrus is highly discriminatory, leading one to inquire, "Why pick on citrus groves?" Perhaps syndication of citrus groves did represent a growing abuse. But by discriminating against citrus, the abuse will merely shift to another crop. Even if the discrimination against citrus could be justified, the rule does not operate uniformly even as to all citrus. In sum, the concept that capital costs should not be deducted is a good one, but it should be more rationally structured and should extend to all farm investments.

EDA

This is the heart of the farm tax program. And the heart is so weak as to suggest that the body would not remain alive for long except for the nostrums which can be administered by Congress from time to time.

One assertion appears to be true: the farm loss problem will continue to exist. While there has been much expression of concern by nearly all members of the tax writing committees,[97] in light of the legislation produced by the hearings, and the mountain of evidence available to demonstrate its ineffectiveness, one is uncertain whether all of these good intentions should be taken seriously. As noted by Mr. Stephen Hart in 1963, the excess deductions account approach which was taken in the Act is the most modest approach which has been suggested.[98] The Chairman of the Senate Finance Committee is hopeful that some other approach may soon be taken.[99] This is an expression of hope in which many would join.

[97] Tax Reform 1969, 2001-184 and Hearings Before the Senate Finance Comm. on the Tax Reform Act of 1969, 91st Cong., 1st Sess., 2710-922, 3491-552, [hereinafter cited as "Tax Reform Act"] are replete with concern over the farm tax loss problem.

[98] See "Tax Reform Act" at 2710 (remarks of Senator Metcalf, September 22, 1969).

[99] 115 Cong. Rec. S17554 (daily ed., December 22, 1969).

Before dismissing this provision out of hand, however, let us once more return to the basis of the farm loss problem—the premature deduction of capital costs. The major problem with the excess deductions account is that it simply is not an effective tool because it fails to recognize the major difficulty in the farm tax area, that is, the ability to deduct currently against nonfarm income expenses which are capital expenditures. While this aspect of the problem may be lessened by the extension of lives for livestock, thereby denying capital gain to more of the sales proceeds, even complete denial of capital gain treatment would not reach the major abuse.

To demonstrate, let us assume a case where net livestock costs (all expenses less sales returned as ordinary income) are just $100 in year *1*.[100] If the livestock is sold in year *2* for $110, there is a net economic profit of $10. The deduction of the net livestock costs of $100 in year *1* yields a tax benefit which, assuming equal tax rates in both years, is just equal to the tax detriment under EDA incurred in year *2* when $100 of the $110 sales price becomes ordinary income. Thus, without considering the benefit of deferral resulting from deducting costs in year *1* while reporting sales in year *2*, the tax cost of year *2* offsets the tax benefit of year *1*, and, just as if costs had been capitalized, EDA permits only the net $10 economic profit to be reported as capital gain. Under the Act, the maximum capital gain rate will become 35 percent.[101] The net tax at capital gains rates would be $3.50 when applied to the economic profits in this case. If capital gain were entirely eliminated, the entire $110 would be reported as ordinary income. The maximum ordinary income tax on the economic profits would be 70 percent or $7 in this case. The maximum benefit then from the rate differential on economic profits will be 35 percent of economic profit or $3.50 in this case.

The example ignores the benefit of deducting $100 in year *1* and reducing taxes on other income. To a 70 percent taxpayer, the deduction against other income results in a tax savings of $70 which is an interest free loan of $70 for one year until the tax is incurred in year *2*.[102] If the taxpayer has an 8 percent discount rate (can earn 8 percent

100 For the purpose of this discussion the $25,000 farm loss and the $50,000 nonfarm income floors under § 211 of the Act are ignored.

101 See H.R. Rep. No. 782 91st Cong., 1st Sess. 317 (1969).

102 Note that the estimated tax does not require an installment repayment of this loan because, ignoring surcharge years, there is no penalty for underestimation of the estimate for year *2* if it were based on year *1* income. Year *1* income was, of course, reduced by the $100 deduction. Thus, there is no sanction for his failing to repay the loan by way of estimated tax. Note also that even if the penalty for underestimation applied, it would be computed at 6% simple interest. This averages out about 3% on the total underestimation. In the usual case, a taxpayer will be able to earn more than the 6% after tax. If the penalty were assessable, which it would not be in this case, the penalty is, of course, not deductible.

after tax), this loan has a value of $5.60 ($8\% \times \$70$). This benefit is greater than the detriment arising from the conversion of capital gain to ordinary income.

While this demonstrates the nature of the problem, the benefit rises sharply if the profit margin is significantly lower. Witnesses before the Ways and Means and Finance Committees suggest that profit margins are around 1 percent to 5 percent.[103] Whether this is a *percentage of the cost of sales* or a *return on capital investment* is not clear. In many of the syndicated operations, cost of sales and capital investment may be nearly equal. The return on the interplay of the tax rules (deduction of raising costs leading to deferral of taxes in that year) is much greater than the tax on the economic profit (whether taxed as ordinary income or capital gains), and the relative value of the tax interplay return increases as the margin of profit declines because the tax payable on the profit declines.

Taxing all livestock gains as ordinary income might be a step in the right direction, but it does nothing to reduce the net difference between the benefit of deferral and the detriment of the tax. But note that if, in the above example, the net profit were $1 (instead of $10), even ordinary income treatment would result in a tax detriment of $.70, which is much less than the $5.60 benefit of the interest free loan. Also, deferral permits the taxpayer to choose to some extent when the income will be realized. A taxpayer having a choice will, of course, attempt to structure realization so as to incur the least tax. Anything short of removal of the deferral benefit will be ineffective, and certainly EDA does nothing to impinge on the sanctity of current deduction.

The Act also fails in another significant respect: it is limited to taxpayers who have a combination consisting of (a) farm losses of $25,000, and (b) nonfarm income of $50,000. The impact will thus be on just a few taxpayers. As has previously been noted,[104] in 1964 there were about 3,000,000 farm tax returns filed by individual taxpayers. Over 1,100,000 of these returns showed farm losses. The EDA in the Act, however, apparently would affect only about 4,000 or 5,000 returns, and even this impact will be significantly reduced since only the loss over $25,000 will go into the excess deductions account. The long range estimate in gross revenue is about $20 million. Thus, the number of taxpayers affected will be small, and the amount of revenue miniscule in comparison with the amount funnelled into some farm investments to take advantage of tax law.

The amount of revenue raised and the number of taxpayers af-

[103] See 1963 Tax Message 1541; Tax Reform 1969, 2035 (remarks of Claude Maer, Jr. on behalf of National Livestock Tax Committee).

[104] See Davenport, supra note 72, at 51-52 for the figures discussed in text.

fected are not, of course, the only criteria by which to measure a provision dealing with the farm loss problem. More importantly, one must ask if the Act will significantly reduce the federal subsidy going to taxpayers having both (a) certain kinds of farm investments and (b) substantial nonfarm income, so as to put them on an equal competitive basis with those farmers who do not have the nonfarm income. The overall purpose thus should be to discourage some investments in farm assets by improving the equity of the tax structure. On this ground, EDA fails. It will permit all comers to incur tax losses up to $25,000 each year. Thus, it seems to fail in reaching a significant number of taxpayers in a meaningful way.

EDA may also be criticized on three other grounds. First, it is so complex as to be almost incomprehensible. Perhaps that degree of complexity could be justified or tolerated if some public purpose were served by it, but none appears. Instead the complexity arises from the application of a poor idea (recapture) to a simple problem (premature deduction of costs). In the area of application, the extent to which recapture should apply is impossible to determine because taxpayers are permitted the use of overly liberal accounting rules. The result is a congery of problems and rules. The problems defy rational solution in light of the accounting rules which farmers are allowed to use. The rules devised are not justifiable, although they are perhaps as rational as one could hope.

The tax writing committees undoubtedly would justify the complexity on the ground that simplicity is thereby preserved for "legitimate" interests.[105] Consequently, those who must deal with complexity are only "illegitimate" interests. In the abstract, this may appear reasonable. But the line between the two kinds of interests is arbitrary and cannot be explained on any rational grounds. Furthermore, many taxpayers who ultimately will prove to be "legitimate," in the sense that they are not subject to EDA, will incur the cost and bother of so ascertaining and, perhaps on audit, so demonstrating. Thus, the complexity has a broader sweep than the "illegitimate" farmer.

Second, as with all recapture provisions, a penalty is exacted only when there is a disposition of property. Thus, one who disposes of property is put at a disadvantage to those who retain property. Similarly, one who sells early is harmed more by recapture than one who sells later. There does not appear to be any reason for so distinguishing between taxpayers. If the tax benefits of premature deduction are intended as a highly inequitable and costly subsidy which prefers

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105 See Griffith and Joy, What the Act Does to the Farmer: Farm Parity or Class Discrimination, 23 The Tax Lawyer, 495 (1970).

high income taxpayers over others,[106] there is little reason to recapture the benefit when sale occurs. If the farm accounting rules which offer these benefits are not intended as a tax subsidy, then they should be repealed, not made more aberrational by recapture.

Third, EDA may be accepted as reform, thereby lessening the demand for some effective change in this area. While this consequence may follow for some short period, we can hope that it is not an enduring result and that those who grew to know and question the farm loss loophole will soon realize that it still exists, almost without any change at all.

V. Conclusion

This discussion closes by recapitulation. There are two forward, but not very significant, steps: the application of section 1245 to livestock and the extension of livestock lives for section 1231 qualification. There are also two backward steps one of which is serious. The hobby loss provision is unwise and seemingly without any justification whatsoever. The special treatment accorded crop insurance proceeds is unwise also, but seemingly is a very minor provision possibly based on the hardship of requiring two years' income to be reported in one and offset by only one year's expenses.

The other provisions are more difficult to evaluate. We could say that the citrus provision is definitely a significant step forward in one area of substantial abuse, but it is much too narrow to be strongly praised; that the recapture of section 175 and 182 expenditures is so small an improvement as to be at best an oblique step turned sharply to the side; and that EDA is at best oblique, and may be wholly to the side—nay, even obliquely backwards—because it seems to be structured so as to remove the matador from the path of the charging reformers, without goring the ox of those who have a somewhat greater than normal vested interest in the present farm tax accounting rules. In general, therefore, the best one can do is to claim a stand-off. An objective evaluation may result in the discovery of more minuses than pluses. But assuming a stand-off, is that really good enough for the much heralded tax reform? One would suppose not.

106 See Surrey, Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures, 83 Harv. L. Rev. 705, 720-25 (1970).